ASSESSORS' HANDBOOK
SECTION 572

GENERAL AUDIT GUIDELINES

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CALIFORNIA STATE BOARD OF EQUALIZATION

Reprint Note

This manual has been renumbered from AH 504.

This manual has been reprinted with a new format and minor corrections for spelling and math errors. The text of the manual has not changed from the prior edition. It has **not** been edited for changes in law, court cases or other changes since the original publication date.

FOREWORD

Many counties do not have a formal method of conducting an audit. An audit, from the preliminary contact with the taxpayer to the placing of an escapement on the roll or a petition for refund, as the case may be, has many ramifications and may be conducted in as many ways as there are counties in this state. With this in mind, we have attempted to write a handbook that will assist the auditor-appraiser in his duties by suggesting specific methods and techniques that he can apply. Many of these methods are already in use by some counties.

Certain sections of the Revenue and Taxation Code that are relevant to audits are cited. Copies of workpapers, including audit checklists and suggested forms, also are included.

We wish to thank the many members of numerous assessors' staffs that contributed time and material toward the preparation of this section.

The Board adopted this Handbook section on July 31, 1974. It is intended to supplement Assessors' Handbook Section 503, *Management of the Business Property Program*, which is under development.

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August 1974

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CHAPTER 1: INTRODUCTION

OBJECTIVE

Most business personal property appraisals are based upon information reported on property statements. For these appraisals to be fair estimates of value, it is imperative that the reported information be accurate and complete. Although most taxpayers will correctly report their property, a minority of taxpayers may be expected to misrepresent their holdings. For this reason the statutes require that the assessor verify the accuracy of property statements long after they have been filed.[1] This verification process is accomplished through an audit program.

The objective of this handbook section is to improve the audit procedures employed by the auditor-appraisers, thereby improving the post-audit program. We hope to achieve this objective by presenting and discussing suggested audit procedures and techniques and by promoting the use of standardized audit working papers.

STATUTORY PROVISIONS

Taxpayers owning or possessing tangible business personal property with a full cash value of $50,000 or more are to be audited at least once in each four-year period.[2] So that the assessor may not be prohibited from reviewing the books of a reluctant taxpayer, the Legislature has provided the assessor with statutory authority to review a taxpayer's records. Revenue and Taxation Code section 441(d) states in part:

> At any time as required by the assessor for assessment purposes, every person shall make available for examination information or records regarding his property.

Revenue and Taxation Code section 462 provides that:

> Every person is guilty of a misdemeanor who (a) Refuses to make available to the assessor any information which is required by Section 441(d) . . . .

Revenue and Taxation Code section 468 provides that where a person fails to supply information or records an assessor may apply to the superior court for an order to compel a person "to appear and answer concerning his property before such court at a time and place specified in the order."

Revenue and Taxation Code section 470 provides that a person shall make his property records available upon request of the assessor.

Many taxpayers and/or their agents are reluctant to show an auditor copies of income tax returns. They should be advised that the assessor is authorized by sections 19286 and 26453(c) of the Revenue and Taxation Code to inspect income and corporation franchise tax returns. These

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[1] Revenue and Taxation Code, section 469.
[2] Ibid., Footnote #1; also California Administrative Code, Title 18, section 192.

sections confer this authority on tax officials of the state, and in *Lyons* v. *Estes* (6 Cal. App. 3d 979) it was held that:

> The county assessor is a tax official within the meaning of section 19286 of this code and may inspect income tax returns to assist him in assessing taxpayer's property.

Revenue and Taxation Code section 454 states in part:

> The assessor may subpoena and examine any person in relation to:
>
> (a) any statement furnished him, or
> (b) any statement disclosing property assessable in his county . . .

PRELIMINARY ARRANGEMENTS AND CONTACTING THE TAXPAYER

Many auditor-appraisers tend to spend little effort on the preliminary audit arrangement and the initial taxpayer contact portion of the audit program. This omission is unfortunate because, with proper planning, this phase of the audit can reduce travel and call-back time. It can also prepare the taxpayer for the auditor's visit and give him a chance to have the necessary records available.

Before you, as the individual auditor-appraiser, receive your audit assignments, there will have been some attempt to arrange your work to certain geographical areas. Once you have received your audit assignments, you should spend some time in arranging them in a logical geographical order. Then prepare a preliminary schedule, so that when you contact the taxpayer, you will have some idea of the most convenient time period for the audit. It is advisable to make some of the appointments on an "open" basis to use as replacements for those that may be canceled on short notice.

Preliminary Contact

Following are some suggested steps for arranging your schedule:

- Contact the taxpayer to find out where the records are located and the name of the person to see. If the records are in the possession of an independent accountant, it is advisable to contact him.
- Contact the taxpayer sufficiently in advance of the audit so that he has time to prepare for your visit.
- Try to set the taxpayer at ease by assuring him the audit is routine and that he is not suspected of any wrongdoing.
- During the initial contact with the taxpayer be sure to mention all the records you will be reviewing and for what period.
- Once you have made a fixed appointment, KEEP IT! Remember that you are an uninvited guest of the taxpayer. There is nothing more aggravating from the taxpayer's point of view

than to be prepared for and expecting an auditor at a fixed time and then the auditor doesn't show. If an emergency should present itself so that it is impossible for you to keep an appointment, first contact your supervisor so that another auditor can replace you if available. If this proves impractical, then contact the taxpayer, explain the problem, and reschedule the audit.

- Where the taxpayer has all the records needed for the audit at his home, you would be well advised to get directions. Considerable time can be lost in searching for a taxpayer's premises.

Chapter 2: Conducting the Audit

Preparation

You will be better prepared to conduct the audit if you accumulate and review the property statements, supporting data, and any correspondence contained in the file. If there has been a previous audit, it should be included in the review. This pre-audit review will familiarize you with the business and enable you to ask more pertinent questions in the interview.

Public Relations

The vase majority of the people you will be auditing are honest, hardworking taxpayers and deserve to be treated as such. The auditor-appraiser is often the taxpayer's only personal contact with the assessor's office. If you are discourteous or argumentative, it not only makes your audit more difficult, but also reflects badly on the entire assessor's staff. To receive the taxpayer's cooperation and respect you should:

- Engender a cooperative attitude by being courteous and cooperative but not overly friendly.
- Decline all offers of gratuities.
- Not engage in unnecessary conversations with the taxpayer's employees.
- Avoid political, religious, or argumentative discussions.
- Avoid drawing premature conclusions.
- Wait until you have several items to discuss before approaching the taxpayer. Interrupting the taxpayer or his staff every few minutes can become irritating.
- Dress and conduct yourself in a manner depicting the professional that you are.

Discussion with the Taxpayer

During the initial interview there are many questions regarding the business enterprise that will save audit time if answered at this point. Information that should be sought includes:

Description of the business.

- Products manufactured.
- Number of employees.
- Number of shifts and days operated.
- Source of raw materials (trade-level).
- Major customers (trade-level).

- Presence on the premises (especially in canneries) of goods that have been sold and are awaiting buyers' orders to ship.

Inventory costing.

- If it is a manufacturing company, the method of costing inventories, including overhead allocations.
- If it is a retail concern, the inventory costing method and basis.
- Date and method of pricing of the latest physical inventory.

Capitalization policy.

- Expensing or capitalizing minimum purchases of assets.
- Expensing or capitalizing sales and use taxes and freight charges.
- Writing off fully depreciated assets.
- Writing off scrapped or sold assets.
- Capitalizing or expensing major equipment repairs.
- Recording trade-in allowances (some companies deduct gains on trade-ins from the cost of the acquired assets).

Existence of a reconciliation schedule between book amounts and the amounts reported on property statements.

Policy on construction-in-progress.

Policy on recording purchases.

- As the goods are received.
- As the items are ordered.
- As the invoices are received.

Policy on recording sales.

Presence of assets at the subject location that are recorded on the books of a subsidiary or parent corporation.

Costs of property located elsewhere.

See Audit Checklist in Chapter 4 for additional questions that can be asked at the interview.

In addition to the above items it's a good idea to find out at this interview what procedure the taxpayer wants you to follow in requesting records, invoices, journals, etc.

PHYSICAL EXAMINATION OF THE PROPERTY

It is advisable to take a tour of the premises after completing the initial interview. The purpose of this tour is to verity the existence and condition of property. It is a vital part of the audit-appraisal, and it should be conducted accordingly.

In touring a manufacturing plant you should review the inventory flow through the various production stages, taking special note of the finished goods storage methods. Your observations should assist you in determining whether any deductions for shortages or damaged goods are warranted.

You should note the general condition of the machinery and equipment and whether there is idle capacity. This is also a good time to take note of the machinery and equipment classifications as personalty or improvements. You should select some fairly old and some fairly new pieces of equipment and take note of the makes, models, and serial numbers so that they can be traced to determine whether they are still on the books or, in the case of the new equipment, whether they have been entered on the books. In some industries large amounts of supplies and small tools are stored in warehouses or tool sheds, but they do not appear on the books as assets because they were expensed when acquired.

Other items to watch for during the tour are consigned merchandise and leased equipment. Take note of these and determine whether either the firm being audited, the consignor, or the lessor has been assessed for the property.

If the records are not located at the property site, you may elect to conduct the tour after completing the audit phase. Whether the tour is conducted before or after the audit, it is imperative that the auditor-appraiser conduct both the tour and the audit before reaching his conclusions.

ACCOUNTING RECORDS

Types of records you may encounter are outlined below:

General Ledger

This is the immediate source from which financial statements are prepared.

Subsidiary Ledgers

These ledgers provide detailed individual balances in support of the general ledger totals.

Books of Original Entry

These are the sales, purchases, cash disbursements, and general journals from which the ledger entries are derived.

Primary Source Documents

These are the documents which serve as the basis for entry in the books of original entry. Examples include:

- Sales invoices
- Suppliers' invoices

Substantiating Documentary Evidence

These documents represent support for the primary evidences. Frequently they relate back to the origins of the transaction. Some examples include:

- Sales orders
- Shipping records
- Copies of bills of lading
- Sales contracts
- Purchase orders
- Receiving records

External Evidences

- Federal and state income or franchise tax returns
- Fire insurance policies
- Statements for credit reports; e.g., National Association of Credit Management, Dun and Bradstreet, Inc., Federal Reserve Banks, and National Credit Office, Inc.
- Reports submitted to the Securities and Exchange Commission, Regulation S-X (Form and Content of Financial Statement) sets out provisions for preparation of balance sheets and income and expense statements by firms from which the commission requires reports.
- Reports submitted to the Civil Aeronautics Board in respect to commercial air carriers.

Company Policies and Practices

- Minutes of the board of directors or shareholders meetings
- Budgets
- Accounting procedure manuals
- Systems of internal control
- Authorizations for major expenditures

Computer-generated Records

The same auditing standards apply equally to examining computer-generated records as they do to examining other kinds of records. The question you should ask yourself is: "What are the ingredients (input data) making up the output records?" Find out what input documents are processed by the computer to generate the output records. An output record you will likely look at is the inventory on hand. **Rest assured that footings and cross footings are mathematically accurate! Don't rest assured that they contain all the elements necessary for estimating full cash value! FIND OUT!**

Behind computer output records are written systems, programs, and instructions – "blueprints" showing how an output record was constructed. Accounting procedures manuals will also shed light on the subject. For example, if you encounter a report entitled *Inventory on Hand for Property Tax Purposes*, you should determine whether its construction differs from inventory-on-hand reports for financial statement purposes. If it does, find out why and how!

AUDIT PROCEDURE

After completing the interview and tour of the plant, the next step is the audit. Select one year to audit in detail, then request a place to work and ask for a chart of accounts, financial statements prepared near the particular lien date, the general ledger, and the supporting journals for the year selected. Then begin verifying the accuracy of the amounts reported on the property statement.

VERIFICATION OF INVENTORY

The typical calculation for computing a lien date inventory consists of starting with the fiscal year beginning inventory or the date of the latest physical inventory, then determining the increase or decrease as the result of sales and purchases to the lien date. Also, it is often advisable to start with the ending inventory subsequent to the lien date and work back; sometimes irregularities can be discovered in this manner.

Beginning Inventory

Some auditor-appraisers accept the fiscal year beginning inventory at face value and are concerned only with the purchases and sales that take place subsequent to that date. This is perhaps too cursory a coverage, since the calculation of the fiscal year beginning inventory (the ending inventory of the previous fiscal year) can affect the lien date inventory to a great extent. Verification of the fiscal year beginning inventory may be accomplished by the following steps:

1. Review the physical inventory and randomly test-check the extensions.

2. Verify that inventory pricing includes all material, direct labor, and burden costs. Some firms employ an inventory costing method known as "direct costing," where fixed overhead charges, i.e., depreciation, plant security, etc., are debited to expense rather than to inventory. If this costing method is used, the auditor-appraiser must add the applicable amount of fixed charges back to beginning inventory and lien date inventory amounts. Where standard costs are used, the auditor-appraiser must determine what costs are included in the standard and how often the standard is adjusted. If the variance accounts are significant the auditor-appraiser must investigate the reasons.

3. Review the inventory cutoff for the fiscal year end and verify that all goods received and sales made prior to the closing are properly accounted for in the inventory calculation. Some firms hold the purchase journal open for two weeks at year end to allow purchases committed during the year to be received and recorded for that year. These same firms may be closing their books on a monthly basis, so in order to make the purchases of the first accounting month appear like a normal amount they will accrue an estimated two-weeks' purchases, then reverse the entry in the last accounting month. The estimated accrual is normally made through a special journal entry and will be charged to a special material account. The point is that this accrual doesn't represent actual purchases and must not be added to inventory by the auditor-appraiser. The accrual of accounts payable should be treated in a consistent manner at both the end of the fiscal year and on the lien date.

4. In auditing companies utilizing natural resources in their manufacturing process, you must make sure that the inventory value reflects the commodity price of the natural resource.[3] Many companies that use natural resources, e.g., stumpage, ore, crude oil, etc., include them in inventory at the cost of extraction. Agriculture co-ops similarly tend to exclude costs of raw products from their finished goods inventories until co-op members are paid for the commodities, e.g., rice, citrus fruit, and nuts.

Purchases

Of primary concern to the auditor-appraiser during this phase of the audit is the assurance that all purchases received prior to the lien date and certain goods in intrastate transit[4] on the lien date are included in the lien date inventory calculation. It is advisable to check accruals made after the lien date to verify that the items were not received prior to the lien date.

The records to examine are the receiving department's reports, the suppliers' invoices, and the purchase journal. There may or may not be copies of the receiving reports filed in the taxpayer's accounting department. If not, then they can be found in the purchasing department and/or receiving department.

The auditor should verify that all items received prior to the lien date have been reported. He should also review the suppliers' invoices for f.o.b. terms to verify whether the intrastate in-transit items are includable in the lien date inventory. He should verify that freight-in amounts are charged to an inventory account rather than to an expense account.

Trade and quantity discounts are clearly deductible in determining cost of goods purchased. These items are not normally given accounting recognition; the cost entered in the records is usually the list price less trade and quantity discounts.

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[3] California Administrative Code, Title 18, section 10(b), Trade Level for Tangible Personal Property.

[4] California Administrative Code, Title 18, section 203 describes when goods in intrastate transit have situs at their destination.

On the other hand, cash discounts are recognized in the records and may appear as either a reduction of the purchase price or as an "other income" item. When the auditor-appraiser encounters cash discounts treated as "other income," he should reduce purchases by the applicable cash discounts.

Sales

The primary concern in reviewing the sales amount for the period from fiscal year end to lien date is the assurance (1) that the sales amount has been adjusted for sales returns and allowances and trade discounts allowed, (2) that all merchandise recorded as sold has actually been shipped from the premises, (3) that merchandise actually shipped has been recorded to sales, and (4) that the sales cutoff dates correspond with the purchases and other accounting cutoff dates.

The auditor should review the sales account for large reversals during the months immediately following the lien date.

Manufacturing Costs

When the audit subject is a manufacturing company, the auditor should verify that all applicable elements of direct labor, other direct charges, and overhead burden have been recorded. Some concerns record fixed charges, such as depreciation or property taxes, on a quarterly or yearly basis or they may exclude such costs completely. In these situations the auditor must verify whether or not the fixed charges have been allocated to the lien date inventory.

Review the general ledger for research or product development accounts. If found, verify that these costs have been amortized to inventory. The amortization can be over the expected life of the asset in years, hours of expected productivity, or over the expected number of units to be produced. For a more complete discussion of research and development cost, refer to Assessors' Handbook Section 571, *The Appraisal of Equipment, Inventory, and Supplies*.

In determining the overhead costs that should be charged to inventory, the auditor has to tread a course somewhere between full absorption costing and direct costing. Full absorption costing holds that all manufacturing costs are chargeable to inventory. On the other hand, direct costing segregates production costs into variable or fixed costs; variable costs are charged to inventory and the fixed costs to expense. Usually some allocation of expenses will be involved in order to exclude from production costs those portions which apply to storage and marketing operations and related general administrative expense.

General and Administrative Costs

The auditor-appraiser should review the general and administrative accounts for charges to be assigned to inventory. The following are examples of accounts that may be chargeable in part to inventory:

- Plant manager's salary, especially if the plant is primarily production oriented.

- Plant protection cost, especially the portion attributable to the security of the work-in-process and finished goods.
- Accounting costs – primarily those of the cost accounting and accounts payable sections.
- Personnel and labor relations costs, especially the portions attributable to hiring of production workers and the negotiation of labor and production contracts.

Purchasing Costs

The costs of the purchasing department should be included in inventory as an addition to the raw material costs. Likewise, the costs of receiving and inspecting the raw materials are proper charges to inventory.

Distribution Costs

Distribution costs are of two general types: those required to bring the inventory to the point of sale and those necessary to consummate the sale. Justification exists for assigning costs of the first type to the finished inventory. However, costs of the second type (e.g., advertising and sales commissions) would be properly charged to selling expense.

Shipping Charges

Shipping charges, like distribution costs, are of two main types: those required to transfer finished goods to customers and those required to move finished goods between divisions or the area warehouses. The movement of finished goods to customers is not a proper charge to the manufacturer's inventory but should be included in the customer's inventory. The costs of shipping finished goods between divisions or to area warehouses adds place utility to the inventory and should be added to its costs. However, the transfer from warehouse to warehouse in search of a market would not be an ordinary business expense, and the costs of those transfers in excess of the original movement to the warehouse should not be considered as an inventory cost.

Inventory Obsolescence

Inventory obsolescence, the loss in value from all causes, may occur in inventories of manufacturers, wholesalers, or retailers. The following discussion should aid you, the auditor, in determining when and if obsolescence exists and whether it should be allowable.

Shrinkage

Shrinkage in the form of scrap and waste is normally encountered in the manufacturing process and involves residual pieces left over from the processing of cloth, lumber, metal, etc. Normal scrap or waste losses are a part of the manufacturing process and should not be deducted in computing the lien date inventory.

Abnormal scrap and waste losses resulting from defective materials or malfunctioning machines may be deducted if the auditor confirms that the abnormal losses have been included in the inventory cost.

Shrinkage at the wholesale or retail levels normally result from theft and breakage. A shrinkage deduction should be allowed if the taxpayer can justify such a deduction from his records, and if the method of calculating the inventory hasn't already taken the loss into consideration. For example, the gross profit method will take these losses into consideration automatically, whereas the retail method may not.[5]

Functional Obsolescence

Functional obsolescence may occur at either the manufacturing, the wholesale, or the retail level. It normally results from changes of taste or from changes in the buying power of customers. A very good discussion of functional obsolescence of inventory is contained in Assessors' Handbook section 571, on pages 124-131.

If idle plant facilities are encountered, the auditor-appraiser should determine whether excess costs are included in inventory.

VERIFICATION OF SUPPLIES

Accountants typically consider supplies as falling within the inventory category. Prior to 1969, the effective date of the business inventory exemption, there was no requirement that business inventories be segregated from supplies. However, since the enactment of the exemption it is the responsibility of the auditor-appraiser to ensure that supplies ineligible for the exemption have been segregated from inventory in the report made by the taxpayer.

The audit of supplies consists of two primary aims which are (1) to ensure that supply items ineligible for the exemption are not included in the reported inventory and (2) to ensure that supplies on hand have been properly reported by the taxpayer.

The first aim can be accomplished by reviewing a sampling of inventory and supply invoices and verifying that only items eligible for the business inventory exemption are being charged to the inventory account.[6]

In verifying that supply items have been properly reported, the auditor-appraiser will normally encounter either of two situations: (1) supplies are being charged to an inventory account or (2) supplies are being expenses as purchased.

Where taxpayers maintain a supply inventory account in the ledger, the auditor must verify that the account is properly maintained and contains all purchases received prior to the lien date.

Where businesses expense supplies as purchased, the auditor-appraiser must review the supply expense accounts over the prior year. Based on this review, on a discussion with the taxpayer regarding the amount of supplies on hand, and on the auditor's findings during the plant tour, he should be able to effectively estimate a lien date supply amount.

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[5] See the discussion in Assessors' Handbook section 571, *The Appraisal of Equipment, Inventory, and Supplies.*

[6] California Administrative Code, Title 18, section 133, *Business Inventory Exemption*, designates those items eligible for the exemption.

VERIFICATION OF MACHINERY AND EQUIPMENT

In the verification of machinery and equipment the auditor is primarily concerned that the acquisition costs and years acquired were properly reported. In accomplishing this verification the auditor is concerned not only that the amounts reflected on the general ledger were properly reported, but that the general ledger amounts correctly reflect the investment in equipment.

Ledger Verification

The general ledger balances may be verified by reconciliation to the detail equipment accounts, depreciation schedules, audited statements, and tax returns.

Additional verification can be made by reviewing purchase documents of selected pieces of equipment and the corresponding journal entries. In this review the auditor should determine that the cost recorded in the equipment account includes freight, sales tax, installation charges, and the full invoice cost before allowances for trade-ins.

The auditor should review credit entries to the equipment accounts occurring during the year(s) being audited and verify that all scrapped, fully depreciated, or sold items have actually been disposed of. He should also review late postings, as many companies have a policy of posting to their ledger accounts on a quarterly basis or posting to asset accounts several months after acquisition dates.

During the initial interview, the auditor should determine the company's policy in expensing or capitalizing equipment. A review of the small tool and supply expense accounts should give a good indication of the types of equipment the taxpayer expenses. If the auditor feels the policy is too liberal, he may choose to estimate an on-hand amount of these items and include it in his appraisal.

There are several different methods of treating tool costs that the auditor should be aware of. Tools are sometimes classified as semi-durable with lives of five years or longer and as perishable with lives of less than five years. Semi-durable tools will be charged to an asset account and treated in a manner similar to other assets. The perishable tools may be charged to an expense account as purchased or charged to an asset account and inventoried annually. Where they are charged to an asset account and inventoried, they may be carried at original cost or at some arbitrary percentage of their cost. In other instances the original purchase of perishable tools may be charged to an asset account and all subsequent purchases are charged to expense. This method and the method that carries the inventory at some arbitrary percentage of cost will understate the company's investment in tools.

Another practice that can lead to undervaluations is that of expensing major repair costs. Repairs that materially extend the life of the asset add value to that asset and should be considered in the appraisal. However, normal maintenance and repair required to keep the equipment in operating condition are properly charged to expense.

Other accounts to review for possible machinery and equipment items are goodwill, prepaid accounts, deferred accounts, and suspense accounts. The automotive account should be analyzed for unlicensed equipment and equipment that is subject to property taxes even though it may be licensed, e.g., steel-wheeled and track-laying equipment and rubber-tire equipment requiring a permit to operate on the highway.[7]

Equipment which may not be carried in the asset accounts includes leased equipment, equipment being purchased under a lease-purchase contract, returnable containers, and self-constructed items. Discovery of the leased items may be achieved by reviewing the lease or rental expense accounts. Existence of returnable containers and self-constructed assets may be discovered during the plant tour.

Leasehold improvement and building accounts should be reviewed for items that qualify as machinery and equipment. In equipment valuation, the auditor-appraiser should make sure that proper allocations are made to the taxable asset accounts when a business is acquired outright or other lump-sum purchases are made. Many businesses will try to allocate more of a lump-sum purchase price to the equipment account than is warranted, because the amounts in the machinery and equipment account are subject to a quicker write-off than amounts in the improvements account. When a taxpayer pays a premium for a going concern, nondepreciable goodwill is often allocated to the machinery values for income tax purposes. The taxpayer who uses this inflated figure for depreciation purposes on state and federal income tax returns may report a much smaller figure to the assessor for personal property taxes.

There is no easy formula or magic way to determine what is "blue sky" and what is a proper value to assign to the machinery and equipment account. The auditor-appraiser must take the facts in each instance and make his determination of value.

Verification of the Reported Amounts

After verifying the ledger balances, the next step is to compare them with the amounts reported on the property statement by year of acquisition. The best source for the acquisition data is the detail equipment ledger or the depreciation schedule.

VERIFICATION OF BUILDING ACCOUNTS

The function of the building accounts audit is primarily to obtain cost information for passing on to the real property section and to review the accounts for possible machinery and equipment that may be included.

The auditor should review the debit journal entries to the building accounts. They sometimes contain complete detail of the various items included in the building costs, especially where the taxpayer has had the building constructed.

[7] See Assessors' Handbook Section 578, Taxability of Vehicles, and Revenue and Taxation Code, section 994.

VERIFICATION OF CONSTRUCTION-IN-PROGRESS

The department of a company which desires capital additions is normally required to submit an appropriation request describing the asset to be acquired, its estimated cost, and justification for acquiring it. Once the request is approved, a work order or construction order is assigned to the project if the asset is to be constructed by the company. If the asset is to be purchased, a purchase order is issued. Where the asset is to be purchased and its construction will take a long period of time, provision for progress payments to the vendor is normally included in the purchase order.

The verification of construction-in-progress involves the matching of expenditures to the existence of physical property. Where progress payments are being made, the books may reflect a considerable amount of expenditures in the construction-in-progress account, but the property may be located at the vendor's premises in another county or out of state.

Progress payments present another problem which the auditor should be aware of. These payments generally are made as reimbursements of expenditures already incurred by the vendor. They may be made periodically, such as weekly, monthly, etc., or they may be made as designated stages of completion have been reached. In either case, the amount expended on the property by both the vendor and the taxpayer will be in excess of what the taxpayer's construction-in-progress account reflects. For example, suppose you are auditing a taxpayer who is having a building constructed on his property. He has agreed to make monthly progress payments reimbursing the vendor for the previous month's costs. As of the lien date, the taxpayer's construction-in-progress (CIP) account will be missing the costs incurred by the vendor during the month of February. Those costs have been incurred by the vendor but have not been reimbursed or booked by the taxpayer. The auditor should adjust the CIP amount for the February billing.

Another item to watch for is the practice of withholding a percentage of the vendor's cost from each progress payment until such time as the asset is completed and approved. The taxpayer's ledger account will be understated by the amount withheld. Still another item to verify is whether the vendor is progress-billing a portion of his profit in addition to his costs. Proper valuation would require that a proration of the profit be included in the CIP cost.

VERIFY ALLOWANCE OF EXEMPTIONS

Some audits will involve determinations of the propriety of exemption allowances. The effect of erroneously exempting property is the same as not assessing it at all. Remember, too, that in a few cases you will find assets properly qualifying for an exemption which have erroneously been assessed. In these cases the exemption should be allowed and refunds made if the taxes have been paid.

The exemption most frequently encountered by auditor-appraisers is the business inventory exemption. If the auditor-appraiser discovers that this exemption has been allowed on inventory or supplies not eligible for the exemption or on inventory excessively reported due to the taxpayer's error, the over-allowance must be enrolled as an escape under section 531.5 of the Revenue and Taxation Code.

Table II-1 shows a list of exemptions applicable to various kinds of personal property.

TABLE II-1

Personal Property Exemptions

Item No.	Kind of Property	Amount of Exemption	Authority for Exemption
1	Business Inventory	50 percent of value for '74-'75 and thereafter	R&T Code sections 129 & 219
2	Goods in Interstate Transit	100 percent of value of qualifying goods	Article I, Section 10, Clause 2, U.S. Constitution
3	Import Goods[8]	100 percent of value of qualifying goods until goods are constructively received in California	Article I, Section 10, Clause 2, U.S. Constitution
4	Export Goods	100 percent of value of qualifying goods	Article I, Section 10, Clause 2, U.S. Constitution
5	Goods Held for Trans shipment	100 percent of value of qualifying goods	R&T Code sections 225 et seq.
6	Motion Pictures	All value except the value of the tangible materials upon which such motion pictures are recorded	R&T Code section 988
7	Pledged good in possession of pawnbroker	Not assessable to the pawnbroker	R&T Code section 989
8	Wine or Brandy held in bond	100 percent of value of qualifying goods after it has been taxed on one lien date	R&T Code section 992
9	Distilled spirits in controlled stock	Applicable federal excise tax	R&T Code section 993
10	Computer programming other than basic operational programs	100 percent of value qualifying programs	R&T Code section 995
11	Personal property of banks and insurance companies	100 percent of value	Article XIII, Sections 27 and 28, California Constitution
12	Property used for libraries and museums that are free and open to the public and property used exclusively for public schools, community colleges, state colleges, state universities, and nonprofit institutions of higher education	100 percent of value of qualifying property	Article XIII, Section 3 (d) & (e), California Constitution
13	Seed potatoes of a grower to be planted during the assessment year	100 percent of value	R&T Code section 232
14	Personal property of retirement funds	100 percent of value	Corporations Code, section 2805

[8] See *Michelin Tire Corp*. v. *Wages, Tax Commissioner*, et al., 46 L. Ed. 2d 495.

CHAPTER 3: TECHNIQUES FOR AGRICULTURAL AUDITS

A handbook on audit procedures and techniques would be incomplete without touching on agricultural audits and some of the problem areas involved.

There are two basic types of agricultural audits – those on crop-producing taxpayers and those on taxpayers that raise livestock – though you will undoubtedly audit some accounts that include both operations.

Under sections 5501 through 5508 of the Revenue and Taxation Code, certain livestock are subject to a "head-day" tax rather than the general property tax. To further complicate matters, certain qualifying racehorses are subject to an in-lieu tax under sections 5701 through 5722 of the Code rather than the general property tax.

AUDIT OF AGRICULTURAL MACHINERY AND INVENTORY

All audit procedures and techniques previously outlined in connection with business personal property audits apply to audits of agricultural machinery and equipment.

DEPRECIATION SCHEDULES AND INCOME TAX RETURNS

The auditor should obtain a copy of the taxpayer's depreciation schedule that itemizes personal property and improvements. The auditor should then review this schedule with the taxpayer because it often contains property that has been sold, traded in, junked, or abandoned and is no longer in use. The taxpayer, of course, should be able to substantiate any and all deletions. The income tax returns are also a good source of information, for it is to the taxpayer's advantage to report and depreciate all his equipment for income tax purposes.

PHYSICAL APPRAISAL

The auditor-appraiser should physically view all major pieces of agricultural machinery and equipment. The condition of the equipment affects value, and equipment on the premises but not listed on the schedule may be discovered. This unlisted equipment might be leased equipment not reported by a lessor or loaned equipment not reported by the owner. During this physical survey the auditor should keep alert for inventory or supplies that may not have been reported by the taxpayer. Property tax rule 133(e) defines personal property held by agricultural enterprises that qualifies as business inventories eligible for the business inventory exemption under section 219 of the Revenue and Taxation Code.

On your tour of the premises, you may encounter furnishings in bunkhouses which are maintained for employees. Upon discovery you should inquire whether the furnishings are owned by the agricultural operation or by the employees. Here a review of the taxpayer's federal or state tax returns may be of assistance. Of course, if the furnishings are owned by the employees, they are exempt from taxation under section 224 of the Revenue and Taxation Code.

CHECK OF BUILDING AND IMPROVEMENT RECORDS

The building and improvement records should be reviewed for items that qualify as machinery or equipment. Such items might include gas storage tanks, small unattached metal storage bins, and movable sprinkler systems.

FARM VEHICLES

Revenue and Taxation Code section 994 provides that all steel-wheeled and track-laying equipment is assessable even though it may be licensed. The section also provides that all rubber-tired oversized and overweight equipment requiring a permit to operate on the highway is assessable regardless of whether or not it is licensed; however, the license fee serves as an offset to the property tax. The section further provides that all rubber-tired equipment not requiring a permit to operate on the highway is not assessable if it is registered and the current license fee has been paid. See Assessors' Handbook Section 578, *Taxability of Vehicles*, for additional discussion.

In order to properly apply the guidelines discussed above, it will be necessary to review each licensed vehicle in some detail.

ANIMALS SUBJECT TO GENERAL PROPERTY TAXATION

Certain cattle, sheep, and racehorses, as defined in sections 5503 and 5703 of the Revenue and Taxation Code, are subject to specific taxes that are in lieu of general property taxes. Also, section 224 exempts pets from taxation if held for noncommercial and noninvestment purposes. Dairy herds, male breeding stock, and horses other than racehorses are the main kinds of livestock that are subject to general property taxation.

The sources of audit information on livestock operations are as varied as the taxpayers, but the following are two major sources available to the auditor.

TAX RETURNS

Federal and state tax returns that list depreciable animals are a good information source. Animals listed on the depreciation schedule of a tax return are not likely to be pets notwithstanding the fact that the taxpayer may represent them as such for property tax purposes.

DAIRY HERD IMPROVEMENT RECORDS

Dairy herd improvement records are an excellent source of information. Dairymen who belong to the Dairy Herd Improvement Association have employees of the association check their cows, weigh the milk, determine the butter fat content, list the number of cows in the herd that are being milked, etc. This information is sent to a data processing center, and the farmer is sent a computer printout of this information on a monthly basis. The same information is compiled by local University of California Cooperative Agricultural Extension Services. The information is summarized in a book, *DHIA Annual Report*, and is available to the general public.

ANIMALS SUBJECT TO HEAD-DAY IN-LIEU TAX

The audit verification problems for animals subject to head-day taxes are different from those encountered in dairy-herd audits. For dairy cattle, we want to know how many were on hand at 12:01 a.m. on March 1; for animals subject to the head-day tax, we need to know how many were on hand for an extended period.[9]

The taxpayer's records, in most cases, are your primary source of information. These records vary from good to nonexistent. The federal and state income tax returns have been previously mentioned as a source of information, but we hope to provide the auditor-appraiser with some of the not-so-obvious sources of information, plus hints on estimating the size of a herd or flock.

FREIGHT BILLS

Freight bills are a good source of information for they provide you with the dates of movement and the number of livestock moved.

BRAND INSPECTION RECORDS

Brand inspection records kept by the Livestock Identification Bureau of the Department of Food and Agriculture in Sacramento are another source of information to the auditor. The auditor-appraiser must search the records in Sacramento at 1220 N Street, but the personnel there will help you locate the records wanted by name and date. The rest is up to you.

Effective January 1, 1974, brand inspection is required on cattle under the following conditions:

At Destination if shipped direct to:

- A registered California feed lot
- A licensed California slaughterhouse
- A licensed or posted California livestock market

At Your Ranch if shipped direct:

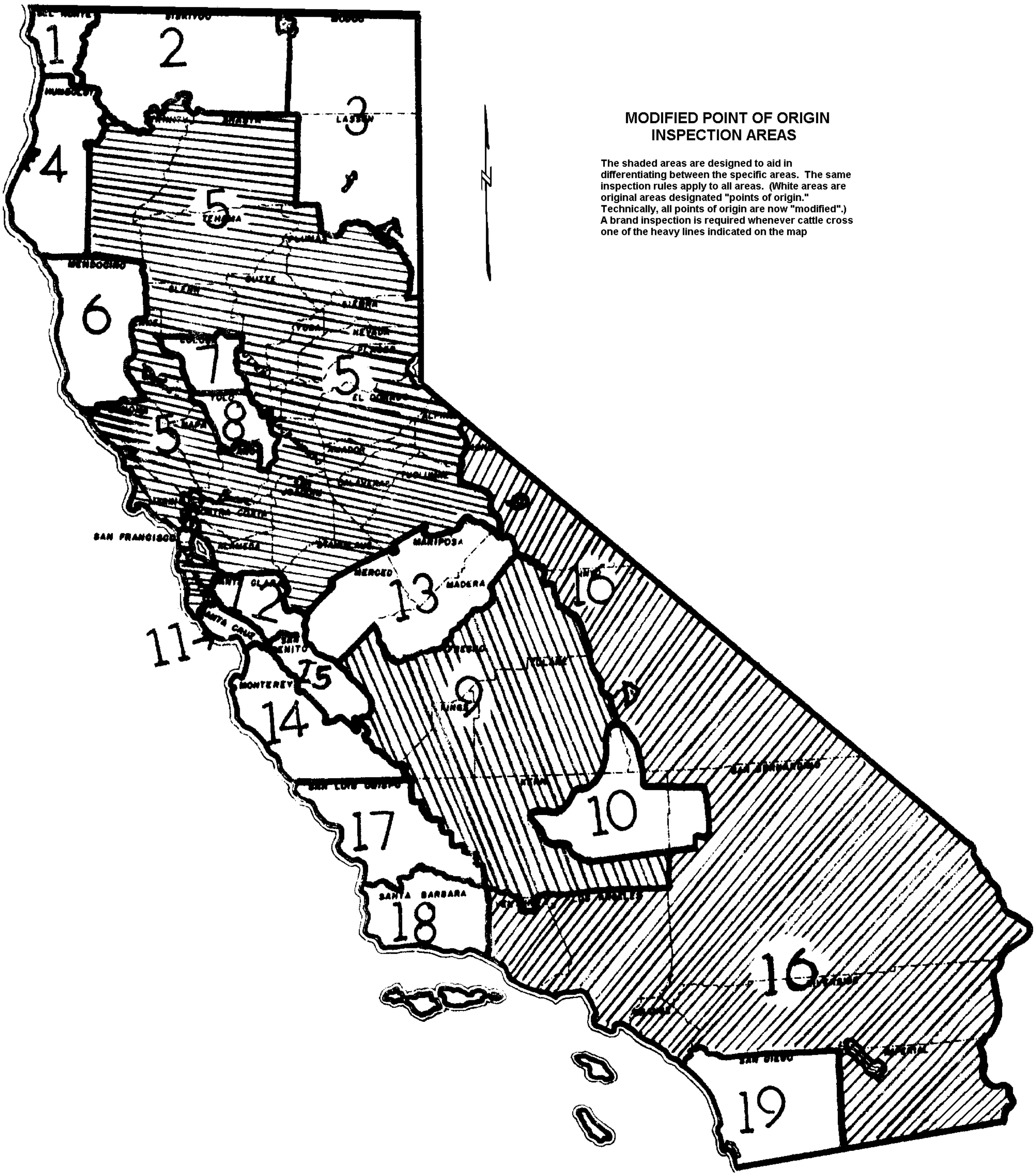
- To an out-of-state location
- To a new owner and not destined to a California feed lot, slaughterhouse, or posted market
- Out of a modified point of origin for **pasture purpose only.**

  (A modified point of origin may consist of one or more counties or geographical areas within the state. The areas are designated as modified points to differentiate them from points of origin, which originally consisted of only 16 areas within the state. See map on the following page.)

[9] See Revenue and Taxation Code sections 5541, 5542, and 5543 for exemptions from this tax.

MODIFIED POINT OF ORIGIN INSPECTION AREAS

The shaded areas are designed to aid in differentiating between the specific areas. The same inspection rules apply to all areas. (White areas are original areas designated "points of origin." Technically, all points of origin are now "modified".) A brand inspection is required whenever cattle cross one of the heavy lines indicated on the map



When brand inspections are required either form number 74-043 or 74-044 must be completed. Both forms will contain the following information.

- Number of cattle inspected
- Types of cattle, e.g., Holstein heifer
- Brand on cattle
- Date of inspection
- Seller of cattle
- Buyer of cattle
- Origin of cattle
- Destination of cattle

FEED-LOT RECORDS

Feed-lot records indicate when livestock are brought in, how many head are involved, the owner, the duration of their stay, and the date shipped out or sold.

COMMODITY CREDIT RECORDS

Commodity Credit Office records should be reviewed for those ovine animals subsidized under the National Wool Act. Owners of animals under this act must file Form No. 1154 with the U. S. Department of Agriculture, Agricultural Stabilization and Conservation Board. Information contained on Form 1154 includes the owner's name, date the sheep were sheared, number of head sheared, total pounds of wool sold, and the amount of money received. If any unshorn lambs were purchased during the reporting period and were sheared in this lot, then the form will contain the number of lambs purchased and their original weight. If any unshorn lambs were sold during the reporting period, the form will contain the number sold and their weight.

GRAZING PERMITS

Grazing permits are issued by federal, state, and local governments. These permits allow livestock owners to graze their animals on government-owned land for a nominal fee per month for each animal. Most permits are issued by the Bureau of Land Management or the Forest Service. A few permits are issued by the state and local jurisdictions.

The permit records reflect number of head, grazing period, location, livestock owner, etc.

The assessor's real property division will normally have information on grazing permits because they use this information in possessory interest assessments.

"RULES OF THUMB"

Following are a few hints that may aid the auditor-appraiser in making estimates when he has some doubt of the validity of the taxpayer's records or when the records are poor or nonexistent.

1. There will be an 85 percent calf crop by April 1 in a cow-calf operation located in the extreme northern portion of the state. Climate and range conditions are key factors in the calving schedule so wide deviations exist in the state. This information can be employed in two ways. If you know the exact number of calves on this date, you can estimate the size of a herd; if you know the size of the herd, you can estimate the number of calves.

2. Sheep are normally sheared once a year except in the San Joaquin Valley and part of the Sacramento Valley where twice-a-year shearing prevails. The shearing expenses can assist you in estimating the number of sheep in a flock.

3. A cow will eat its own weight every 30 days. If a farmer is buying feed for all his cattle, the average weight of the particular breed divided into the total feed tonnage for a period will give you an estimate of the average number of head of cattle for that period.

4. Gross income from taxpayers' records on dairy herds provides another tool. The Agriculture Extension Service can generally provide you with the average amount of milk a particular breed of cow will give and the price paid for this milk. The gross income divided by the average income from one cow gives an estimate of the size of a herd.

The foregoing are all methods of making estimates and are not a means of calculating an exact inventory for any period. A variance of 10 to 20 percent of livestock may not be discovered by using any of the above methods, but you should be able to discern larger discrepancies.

THE TAXATION OF RACEHORSES

Racehorses are subject to an annual head tax rather than the general property tax. The amount of the tax depends upon a variety of characteristics such as sex, age, and earnings. (See R&T Code, sections 5701-5722 and California Administrative Code, Title 18, section 1045.)

A good source of information on racehorses is the *Stallion Register and Statistical Review*, published on a yearly basis by the California Thoroughbred Breeders Association. This is a comprehensive publication on racehorses that cites earnings, stud fees, and broodmare information.

Other sources which yield much valuable information on racehorses are *The Thoroughbred of California*, published by the California Thoroughbred Breeders Association, 201 Colorado Place, Arcadia, California 91006, and *The California Turf Directory*, P.O. Box 168, San Mateo, California 94407. The California Horse Racing Board located at 205 S. Broadway, Los Angeles, California 90012, maintains a list of racehorse owners who are licensed to race horses in California.

CHAPTER 4: AUDIT GUIDES AND WORKPAPERS

Every audit, regardless of its complexity or the size of the firm, should contain certain basic information – minimum contents – including (1) summary of findings, (2) a WRITTEN narrative in sufficient detail to tell the reviewer **at a later date** what happened, and (3) working papers.

The arrangement of the contents should flow logically following a standardized format. Attach pieces of paper together with permanent fasteners and number the pages of your audit sequentially because the piece of paper that gets "lost" is often the one that contains key information.

In addition to the minimum contents mentioned above, an audit checklist is of vital importance if an audit is to be thorough and efficient. The audit checklist illustrated in this chapter contains questions pertinent to the taxpayer being audited as well as leading reminders relating to the various segments of the audit. These reminders may be checked off as covered by the auditor-appraiser. The checklist covers most areas that you will encounter in your various audits. You may wish to separate the items into three or four checklists, such as for retail audits and manufacturing plant audits, with a different checklist for the degrees of difficulty.

AUDIT CHECKLIST

1. GENERAL INFORMATION

a. Description of the business? ______________________________

b. Number of employees? ______________________________

c. Number of shifts per day and days per week that the facility operates? ______________

d. Is there an internal audit section? If so, to whom does it report? ______________

____

e. When did this business start operations? ______________________________

f. Was the business purchased from others by the present owners, or was it begun as a new business? ______________________________

g. Has this business acquired other businesses in this county? ______________________

h. Has there been an independent audit performed recently? If so, by whom? Is a published report available? ______________________________

____

i. Are the records kept on a calendar year or fiscal year basis? If fiscal year, when does it close? ______________________________

2. INTERNAL CONTROL

a. Are the written procedures adequate to provide reasonable accounting control over assets, liabilities, revenues, and expenses?

b. Are internal auditors employed?

c. Are source documents maintained in support of transactions?

d. Are transactions and journal entries properly authorized and approved?

e. Are physical control procedures adequate to prevent excessive losses of assets?

3. INVENTORY – GENERAL QUESTIONS

a. Do inventories include:

(1) Raw materials?

(2) Purchased parts?

(3) Purchased finished goods?

(4) Supplies?

(5) Work-in-process?

(6) Manufactured finished stock?

(7) Imported goods or goods held for export?

b. Are purchased items obtained from:

(1) Outside suppliers?

(2) Subsidiaries?

(3) Other divisions of the parent firm?

c. Is accounting for inventory based on:

(1) Perpetual inventory records?

(2) Periodic physical inventories only?

(3) Apportionment of long-term contract costs?

d. Are all classes of inventory physically inventoried at least once a year?

e. Do written instructions for physical inventories include instructions relating to the following:

(1) Methods of determining quantities?

(2) Cut-off of receipts and deliveries?

(3) Segregation and description of slow-moving, obsolete, and damaged items?

(4) Merchandise on hand owned by others?

(5) Goods-in-transit?

f. Is there written approval by a responsible employee of all adjustments to inventory control accounts?

g. Do procedures exist for periodic reporting of the following:

(1) Slow-moving items?

(2) Obsolete items?

(3) Overstocks?

(4) Damaged items?

h. Are there periodic confirmation reports for the following classes of inventory:

(1) Consignments in?

(2) Inventory in the hands of processors and suppliers?

(3) Inventory in warehouses?

(4) Returnable containers in the hands of customers?

(5) Floored merchandise?

i. Are detailed perpetual inventory records maintained in quantities and dollars for:

(1) Raw materials?

(2) Purchased parts?

(3) Work-in-process?

(4) Finished stock?

(5) Consignments out?

(6) Inventory in warehouse?

(7) Returnable containers in the hands of customers?

(8) Items charged to expense but physically on hand, such as supplies, small tools, and obsolete stock?

(9) Supplies charged to asset accounts?

j. Are perpetual records adjusted to physical quantities at least once a year?

k. Are perpetual inventory dollar amounts computed and compared periodically with general ledger control accounts?

l. Do formal merchandise receiving reports exist?

(1) Are names of vendors, descriptions of materials, and quantities listed in detail?

(2) Are purchases recorded upon arrival at the receiving department? If not, what is the duration of the time lag?

m. Does the inventory qualify as "business inventories?"[10]

4. INVENTORY – RETAIL

a. Is the inventory priced at the lower of cost or market, cost, or other?

b. If priced at cost, what method is used?

(1) FIFO

(2) Moving average method

(3) LIFO[11]

(4) Retail

(5) Other

c. Is merchandise consigned either to or from others?

d. Is floored inventory at the location?

e. Are there claims for import-export exemption?

f. Is some of the inventory out-of-county?

5. INVENTORY – PROCESSING OR MANUFACTURING

a. Is the cost system tied into the general ledger?

b. Are overhead rates reviewed periodically and adjusted to current experience?

c. Are separate control accounts maintained for:

(1) Inventory costs applicable to work-in-process?

(2) Inventory costs applicable to finished goods?

(3) Manufacturing expenses (overhead)?

(4) Manufacturing expenses absorbed in production?

(5) Variance accounts (when standard costs are used) for:

(a) Raw materials?

---

[10] See Revenue and Taxation Code, sections 129 and 219, and California Administrative Code, Title 18, section 133, Business Inventory Exemption.

[11] Remember that the LIFO method tends to understate the inventory value during periods of rising prices, consequently, it is not an acceptable method for property tax purposes.

(b) Direct labor?

(c) Overhead?

(6) Physical and price adjustments?

d. Is interdepartment, interplant, or interdivision profit included in inventory?

e. Are only direct costs, i.e., direct labor, direct material, etc., charged to inventory, or are all applicable costs including indirect costs charged to inventory?

f. Is gross profit on sales determinable by:

(1) Product?

(2) Selling department?

g. Is a breakdown by products maintained for the following cost elements:

(1) Raw materials (purchases)?

(2) Direct labor?

(3) Manufacturing expenses (overhead)?

6. SUPPLIES

a. Are supplies expensed as purchased or as consumed? If expensed when purchased, determine the normal amount on hand.

b. Do the supplies qualify as "business inventories?"

7. EQUIPMENT

a. View the equipment during the plant tour for classification purposes.

b. During the tour select some very old and some very new equipment for tracing through the records to determine whether the old equipment is on the books or written off. Trace new equipment to the invoices to determine whether the date received coincides with the date entered in the records.

c. Trace a sampling of the more expensive pieces of equipment to the purchase invoices to verify that the recorded costs include taxes and freight.

(1) Determine that installation costs are properly capitalized.

(2) Review charges and credits to the asset account.

d. Review the mobile equipment account for vehicles not licensed or otherwise assessable.[12]

e. Review the capitalization policy for expensing or capitalizing equipment. Are finance charges expensed?

f. Review the repair and maintenance account for major repairs that may extend the life of equipment.

g. Check rental expense accounts for payments for leased or rented equipment not otherwise reported.

h. Verify that self-constructed equipment has been properly charged for all construction and overhead costs.

i. Verify that intercompany or interdivisional equipment transfers are recorded and that the values and dates of acquisition are correct.

j. Compare the general ledger amounts to the amounts reported on the property statement by year of acquisition.

8. BUILDINGS, LEASEHOLD IMPROVEMENTS, ETC.

Verify that the land improvements, buildings, leasehold improvements, and construction-in-progress accounts have been properly reported on the property statement.

9. AUDIT SUMMARY

a. Prepare audit schedules and audit summary.

b. Complete a brief audit narrative and auditor's recommendation.

c. Review with the taxpayer.

d. Submit the completed audit to your supervisor.

[12] See Assessors' Handbook, Section 578, *Taxability of Vehicles*.

AUDIT COVER SHEET

An audit cover sheet is a valuable aid in organizing and retaining pertinent information relative to an audit. The following illustration suggests a format which can be added to or reduced to suit your particular needs.

1. Taxpayer's Name ______________________________

2. Parcel or Account No. ______________________________

2a. DBA ______________________________

3. Mailing Address ______________________________

4. Situs Address ______________________________

5. Records Located at ______________________ Zip Code __________

6. Person Contacted ____________________ Telephone ______________

7. Date Audit Assigned ______________ Completed ________________

8. Years Audited 19 ___, 19 ___, 19___, 19___, 19___, 19___.

9. Stratum ______________________________

10. Auditor's Name and/or Employee Identification Number __________________

____

11. Hours Charged ______________________________

11a. Audit Units ______________________________

12. Reviewer's Name ________________________ Date __________

Indicate with an $\boxed{\text{X}}$ the exhibits and schedules included with this audit.

- ☐ Exhibit I – Summary of Audit Findings
- ☐ Exhibit II – Audit Narrative
- ☐ Schedule A – Inventory
- ☐ Schedule A1 – Supplies Qualifying as Business Inventories

- [ ] Schedule A2 – Supplies Not Qualifying as Business Inventories
- [ ] Schedule B – Office Furniture and Equipment
- [ ] Schedule C – Store, Restaurant, Warehouse Equipment
- [ ] Schedule D – Machinery and Equipment
- [ ] Schedule E – Tools, Dies, Molds, and Jigs
- [ ] Schedule F – Equipment Leased from Others
- [ ] Schedule G1 – Leasehold Improvements
- [ ] Schedule G2 – Land
- [ ] Schedule G3 – Land Improvements
- [ ] Schedule G4 – Structures
- [ ] Schedule – Other

SUMMARY OF AUDIT FINDINGS

The summary of audit findings illustrated below is designed so that attention is directed to the differences discovered by audit. Only these differences need to be processed to value conclusions.

EXHIBIT I

Summary of Audit Findings for Year 19 ___

Acct.[13] No(s) (a)	**Sch. Ref. (a-1)**	**Item (b)**	**Cost**			**Full Cash Value Difference (f)**
			Reported (c)	**Audited (d)**	**Difference (e)**	
		Inventory				
		Supplies				
		Office Furn. & Equip.				
		Store, Rest. Whse., Equip.				
		Machinery & Mfg. Equip.				
		Tools, Molds, Dies & Jigs				
		Construction-in-Progress				
		Structures				
		Land Improvements				
		Land				
		Other				
		Total				
		Sub-total – Land				
		Sub-total – Fixtures (imps.)				
		Sub-total – Other Imps.				
		Sub-Total – Personalty				
		Total				
		Inventory Exemption Adjustment – Full Cash Value				

Enroll Difference Pursuant to R&T Code

Section(s): ________________	531	Increase
________________	531.1	Increase
________________	531.2	Increase
________________	531.3	Increase
________________	531.4	Increase
________________	531.5	Increase
________________	4831	Reduction/Increase
________________	4831.5	Reduction

[13] Column (a) should contain the taxpayer's ledger account number for each category.

THE AUDIT NARRATIVE

A written narrative is a key feature of the audit. It should summarize the salient points of the findings, including the areas of discrepancy and their causes. The taxpayer's methodology in preparing his property statements should be explained if he is at variance with prescribed standards.

The narrative should logically follow the sequence of the working papers. It should cover significant points in enough detail so that a reviewer at a later date can follow your story. If, for example, inventory is significant and arbitrary reductions have been made on the property statement with no real substantiation, point this fact out. Point out how the inventory accounting system is designed to accommodate and recognize defective merchandise.

Clear explanations are necessary so that you and your supervisor will be able to discuss your findings intelligently with the taxpayer.

In effect, the audit narrative is a summary of your findings, your conclusions as a result of the findings, and your recommendations for or against penalties. In all instances you should render your opinion(s) and reason(s) for any change(s) made to the original assessment(s).

Notes should be made and added to the audit narrative in regard to post-audit conferences. Any changes to your audit figures as a result of these meetings with the taxpayer should be included.

AUDIT WORKPAPERS

The following are samples of audit information sheets and workpapers that the auditor-appraiser may use. On some audits, you may have to use your ingenuity to prepare your own schedule(s).

Inventory Computation Worksheet

Gross Profit Method

Beginning Inventory ____________________ (Date)		$ ______________
Adjustments to Beginning Inventory:		
Add ____________________________ (Describe)	______________	
Delete __________________________ (Describe)	(______________)	
Adjusted Beginning Inventory:		______________
Add:		
Purchases	$ ______________	
Add ______________________ (Describe)	______________	
Delete ____________________ (Describe)	(______________)	
Adjusted Purchases		______________
Freight		______________
Direct Labor and Manufacturing:		
Overhead		______________
Total Available for Sale		______________
Sales	______________	
Less: Gross Profit (see gross profit percentage worksheet)	(______________)	
Cost of Goods Sold		______________
Computed Inventory		$ ______________

Computation of Inventory by Use of Gross Profit Percentage

When a lien date inventory is to be computed by the gross profit percentage method, the auditor can use the taxpayer's personal income or corporation franchise tax return to ascertain the experienced gross profit percentage for the latest fiscal year.[14]

Be careful not to mismatch income and expenses when computing the lien date inventory by this method. For example, an appliance dealer will generally have both labor sales (repairs) and merchandise sales. By including the labor sales in the total sales and only merchandise costs, you will overstate the gross profit percentage and consequently the computed lien date inventory.

A second major precaution to take when using the gross profit method is to determine whether the goods in the inventory have substantially similar gross profit ratios. If they do not, the use of an overall margin may distort the amount of computed inventory.

Computation of Gross Profit Percentage Worksheet

Line No.	Item	
1.	Inventory (Beginning of accounting period prior to year under audit)	$ ______________
2.	Add: Purchase (For the prior accounting period)	______________
3.	Freight-in (For the prior accounting period)	______________
4.	Total Available for Sale	______________
5.	Less: Inventory (End of accounting period prior to year under audit)	(______________)
6.	Cost of Goods Sold (For the prior accounting period)	______________
7.	Sales (For the prior accounting period)	______________
8.	Cost of Goods Sold Percentage (Line 6 ÷ line 7)	______________%
9.	Gross Profit Percentage (100% – line 8)	______________%

[14] See Assessors' Handbook Section 571, *The Appraisal of Equipment, Inventory and Supplies*, for detailed information concerning the use of the gross profit method of computing inventory.

Inventory Exemption Adjustment Worksheet

Description	19 ___	19 ___	19 ___	19 ___
Inventory Overreported	$ ______	$ ______	$ ______	$ ______
Items Incorrectly Reported as Eligible Inventory:	______	______	______	______
Supplies	______	______	______	______
Leased Equipment	______	______	______	______
Other	______	______	______	______
Total	$ ______	$ ______	$ ______	$ ______
Exemption Percentage	______%	______%	______%	______%
Exemption Adjustment[15]	$ ______	$ ______	$ ______	$ ______

Equipment Worksheet

Type of Equipment ____________________

Account No. ________________________

Item	19 ___	19 ___	19 ___	19 ___
Balance per Books & Records	$ ______	$ ______	$ ______	$ ______
Add: Received but Not Posted	______	______	______	______
Fully Depreciated–Written Off	______	______	______	______
Other	______	______	______	______
Sub-total	______	______	______	______
Less: Nonexistent Items	(______)	(______)	(______)	(______)
Real Estate Items	(______)	(______)	(______)	(______)
Out of County/State	(______)	(______)	(______)	(______)
Other	(______)	(______)	(______)	(______)
Total Audited Cost	______	______	______	______
Less: Reported Cost	(______)	(______)	(______)	(______)
Difference	$ ______	$ ______	$ ______	$ ______

[15] The incorrectly allowed business inventory exemption should be enrolled as an escape under R&T Code section 531.5.

Equipment Worksheet

By Year Acquired

19____Value Factor Reference ____________________

Year Acq'd.	Reported Cost	Audited Cost	Difference	Full Cash Value of Difference
19 ____				
19 ____				
19 ____				
19 ____				
19 ____				
19 ____				
19 ____				
19 ____				
19 ____				
19 ____				
19 ____				
19 ____				
19 ____				
19 ____				
19 ____				
19 ____				
19 ____				
19 ____				
19 ____				
19 ____				
Prior				
TOTAL				

Remarks: ____

____

Leased Equipment Worksheet[16]

Equipment Description	Name and Address of Lessor	Year of Lease and Period	Rental Cost (Indicate Term)	Cost if Purchased

[16] This worksheet can be used in detailing the leased equipment held by the lessee.

Leasehold Improvements Worksheet[17]

Total Leasehold Improvement Costs Reported $______________

Detail Costs Per Audit:

____ ______________
(Describe)

____ ______________

____ ______________

____ ______________

____ ______________

____ ______________

____ ______________

____ ______________

____ ______________

____ ______________

____

Total Per Audit $______________

Variance – Costs Per Audit Minus Costs Reported $______________

Explanation of Variance:

____

____

____

[17] This worksheet can be used in detailing leasehold improvement costs.

Land Worksheet[18]

Total Land Costs Reported	$ ________
Per Audit:	
Land Acquisition Costs	________
Add Costs Found to be Expensed:	
Realtors' Commissions	________
Attorneys' Fees	________
Draining and Filling	________
Clearing and Grading	________
Removal, Relocating, and Reconstructing Property of Others to Acquire Possession	________
Total Per Audit	$ ________
Variance – Cost Per Audit Minus Costs Reported	$ ________

Reasons for Variance(s):

____

____

____

____

[18] The land worksheet can be used to determine whether all land costs have been capitalized.

Land Improvements Worksheet[19]

Total Land Improvement Costs Reported	$________
Detail Costs Per Audit:	
________________ (Describe)	________
________________	________
________________	________
________________	________
________________	________
________________	________
________________	________
________________	________
________________	________
________________	________
	________
Total Per Audit	$________
Variance – Costs Per Audit Minus Costs Reported	$________

Explanation of Variance:

____

____

____

[19] This worksheet can be used in detailing the land improvements account.

Structures Worksheet[20]

Structure Identification ______________________________

Total Structure Costs Reported $ __________

Detail Cost Per Audit:

Site Preparation, Drawings, Foundation,
Walls, Roof, and Exterior __________

Lighting – to Service Building __________

Plumbing – to Service Building __________

Air Conditioning and Heating – to Service Building __________

Drapes and Floor Covering __________

Wiring, Plumbing, Special Construction and
Foundations, etc., to Service Machinery and Equipment[21] __________

Other ______________________________ __________
(Describe)

______________________________ __________

Total Costs Per Audit $ __________

Variance – Costs Per Audit Minus Costs Reported $ __________

Explanation of Variance:

____

____

____

[20] The structures worksheet can be used to record the detail structure costs as well as any discriptive data deemed necessary.
[21] Costs in this category should be reclassified as equipment.

Construction-In-Progress Worksheet[22]

Cost Verification

Item	19 ___	19 ___	19 ___	19 ___
Total Costs Reported	$ ________	$ ________	$ ________	$ ________
Total Ledger Costs	________	________	________	________
Add: Completed or Received but not Recorded	________	________	________	________
Capitalized Interest[23]	________	________	________	________
Other	________	________	________	________
Sub-Total	________	________	________	________
Less: Posted not Received	(________)	(________)	(________)	(________)
Non-Situs Items	(________)	(________)	(________)	(________)
Items of Expense	(________)	(________)	(________)	(________)
Other	(________)	(________)	(________)	(________)
Total Audited Cost	________	________	________	________
Less: Costs Reported	(________)	(________)	(________)	(________)
Variance	$ ________	$ ________	$ ________	$ ________

Classification of Variance

Item	19 ___	19 ___	19 ___	19 ___
Land	$ ________	$ ________	$ ________	$ ________
Improvements:				
Land Improvements	________	________	________	________
Structures	________	________	________	________
Fixtures	________	________	________	________
Personalty	________	________	________	________
Nonassessable (Describe)	(________)	(________)	(________)	(________)
Total Variance	$ ________	$ ________	$ ________	$ ________

Explanation of Variance:

____

____

____

[22] This worksheet may be used in reconciling the individual construction-in-progress projects as well as the total account.

[23] Capitalized interest is the amount of interest on advances to vendors or funds expended on self-produced projects more than one year prior to the delivery of the property or completion of the self-produced project. The interest amount may be capitalized and shown in the books, but more likely, it will require calculating. In calculating the amount, you should use the prime interest rate effective at the time and estimate the average investment in the project from the start of production to the lien date.

CHAPTER 5: FORMS

The following pages contain examples of forms in use in many assessors' offices. Those included are:

- Acknowledgment, concurrence, and comments by taxpayer.
- Agreement to waive Statute of Limitations (Revenue and Taxation Code, section 532).
- Notice of impending audit.
- Notice of audit results.

Acknowledgment, Concurrence, and Comments by Taxpayer

Taxpayer hereby acknowledges that he has received a copy of auditor's worksheets for March___, 197___, March___, 197___, March___, 197___, March___, 197___, and has reviewed the figures shown thereon for each of the specified lien dates as determined from taxpayer's books and records, and has the following comments:

( ) Figures are true and correct.[24]

( ) Figures are not correct (explain by attachment).

Other Comments:

Taxpayer further acknowledges that the figures represent audit data only. The final decision as to value will be made by the assessor's staff.

Date: ______________________ ______________________

DBA or Firm Name

By:______________________

Name and Title

[24] Concurrence in the auditor's figures does NOT bind taxpayer to any assessed values which may be derived; concurrence is limited solely to the accuracy of the lien date amounts as determined by the auditor.

Agreement to Waive Statute of Limitations
(Revenue and Taxation Code, section 532)

To: ________________________________

Assessor of ________________________ County

The period of limitations specified by section 532 of the Revenue and Taxation Code within which an escape assessment of property for 19___ may be made for purposes of property taxation will expire after June 30, 19___. The County of __________________________ is engaged in or is contemplating an audit of the undersigned's property situated in the county on the lien date 19___.

In consideration of the assessor's forebearance to make an escape assessment for 19___ prior to July 1, 19___, ____
(Person or Corporate Name)

hereby agrees to waive all rights and privileges conferred by the statute of limitations specified by section 532 of the Revenue and Taxation Code until

_____________________, 19___.
(Date)

Signed ____

Title ____

If Incorporated ____________________________________
(Complete Corporate Name)

Accepted: __________________________________

Assessor, County of __________________________

By __________________________
Deputy

Notice of Impending Audit

Taxpayer's Name and Address

Reference:

Gentlemen:

We have assigned a member of our auditing staff to audit your property statements filed with this office for the years 19___, 19___, 19___, and 19___.

In accordance with the provisions of the Revenue and Taxation Code of California, we request the opportunity to examine your books and records containing information regarding property located in ___________________________ County which was owned, controlled, or possessed by you on the tax lien dates of those years.

Our auditor will contact you for a mutually convenient appointment. We will appreciate your cooperation.

Very Truly Yours,

Notice of Audit Results

Taxpayer's Name and Address

Reference:
Date:

Gentlemen:

As a result of our recently completed audit, we plan to make the following changes to the assessment roll:

Item	Tax Year			
	19__ – __	19__ – __	19__ – __	19__ – __
Inventory	$ ________	$ ________	$ ________	$ ________
Supplies	________	________	________	________
Office Furniture and Equipment*	________	________	________	________
Machinery and Equipment*	________	________	________	________
Construction-in-Progress*	________	________	________	________
Other __________________________	________	________	________	________
__________________________	________	________	________	________
Inventory Exemption	________	________	________	________
Penalty ____%	________	________	________	________
NET CHANGE	$ ________	$ ________	$ ________	$ ________

* Property which is affixed to real estate will be assessed as improvements.

Positive net changes are escape assessments which will be added to the roll on ________________ (date). Negative net changes ( ) are overassessments which will be corrected under the provisions of sections 4831 or 4831.5 of the Revenue and Taxation Code. You have the right to apply for a refund of taxes which you paid on such overassessments (section 5096 of the Revenue and Taxation Code).

If you have any questions concerning these findings, please call us at ________________________ (phone number) on or before ______________________________________ (same date as above).

Thank you very much for your cooperation in this matter.

Very truly yours,

CHAPTER 6: GLOSSARY

Cost Phraseology

Capitalize – When used in the context "to capitalize an asset" it indicates that, upon acquisition, the cost of a property is debited to an asset account rather than to an expense account.

Direct Costing – A method of accumulating only prime costs (direct labor and direct material) plus variable overhead to the inventory account. The remaining overhead costs (fixed costs) are charged to expense rather than to inventory. Consequently the inventory will be understated and is not acceptable for assessment purposes.

Fixed Costs – Overhead costs that continue at a fairly constant level even though production activity may drop or increase.

Standard Costing – A system of charging a predetermined amount for each production activity. The predetermined amount is based on the best estimate of what an activity should cost. At regular intervals standard cost and actual cost should be compared and the standards should be adjusted accordingly.

Full Absorption – Also referred to as full costing, whereby all elements of manufacturing cost – direct materials, direct labor, and all overhead – are accumulated as a part of inventory cost.

Variable Costs – Costs that change with the level of productive activity, such as increases in utility costs due to adding an extra work shift.

Inventory Phraseology

First-in, First-out (FIFO)	–	Method of valuing inventory that presumes those products purchased first are used or sold first; consequently, the most recent costs are reflected in inventory.
Last-in, First-out (LIFO)	–	Method of valuing inventory that presumes those products purchased last are used or sold first; therefore, the inventory would not reflect current costs. This method is not acceptable for property tax purposes.
Moving Average	–	All costs of purchasing or producing merchandise are added to the existing stock. After the addition of the most recent units, the total number of units on hand is divided into the total cost to arrive at an average cost. The resulting inventory value approximates current costs. It is an acceptable method for property tax purposes.
Retail Method	–	A method of estimating inventory that is used by many retail concerns. This method utilizes the ratio which cost bears to the total retail price of ending inventory so that the inventory, priced at retail, may be converted to an estimate of inventory at cost.
Gross Profit Method	–	Another method of estimating the cost of the ending inventory. This method utilizes the cost of the beginning inventory plus the cost of purchases (or finished goods produced) for the current period, less the cost of sales for the period. The result is an estimate of the inventory at the end of the period under consideration. The cost of sales amount is derived by multiplying the gross profit percentage experienced for the most recent prior period by the sales for the interim period and subtracting the result from sales.